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Australia releases exposure draft legislation on reform of foreign-source income deferral rules

Australia's Assistant Treasurer released draft legislation on 17 February 2011 to implement the reform of the controlled foreign company (CFC) rules and introduce the foreign accumulation fund (FAF) rules. The proposed changes are part of a broader package of reforms announced in the 2009/2010 Budget and mark the next stage of what has been several years of consideration by the Board of Taxation and Treasury, and consultation with business and the tax profession, to modernize these rules.

Key changes to the CFC rules

As compared to the consultation papers issued in 2010, the draft legislation eliminates certain compliance obligations, but also waters down the active income exemption from what was previously proposed. The key changes are as follows:

Active CFC test exemption – Previously referred to as the "*de minimis passive income*" exemption, the active CFC test still provides an exemption from attribution if less than 5% of the income of the relevant CFC has a passive character but now is tested by reference to the "financial accounts" of the CFC, instead of "audited financial accounts." This change removes the compliance burden where CFCs are not required to prepare audited financial statements.

Active business income exemption – This exemption has been revised to take into account the concerns raised about the uncertainty of the circumstances in which the exemption would apply. A new definition of what will constitute "*income of an active character*" has been introduced, together with a new concept of "*disconnected income*," which must be satisfied before the active business income exemption will apply. Broadly, where a CFC derives *prima facie passive income* and the source of the income, the market and use of labor does not have a substantial connection with the country in which the CFC has a permanent establishment (PE), such income will be attributable. This represents a substantial watering down of this exemption compared to what was previously proposed by Treasury.

"Integrity rule" – An "integrity rule" still applies and includes an amount of *prima facie passive income* in the attributable income of a receiving CFC to the extent the *prima facie passive income* has given rise to an Australian tax benefit (i.e. a deduction, change in the cost base of a capital gains tax asset or a tax offset) for the attributable taxpayer for the CFC or an associate of the attributable taxpayer for the CFC. The integrity rule was previously expressed as denying a tax benefit to the payer. Following submissions by the business community, Treasury has acknowledged that this outcome was inappropriate as a gross deduction was being denied to the provider instead of including an amount of income net of expenses in the attributable income of the receiving CFC.

CFC grouping relief – The draft legislation still provides that *prima facie passive income* that is referrable to a financial benefit received from a member of the same CFC group is not attributable. However, grouping relief will only apply where the financial benefit has not given rise to a deduction in calculating the attributable income for the CFC that provided the benefit. Otherwise, the relevant *prima facie passive income* is required to be included in the attributable income of the CFC in receipt of the financial benefit.

Exclusion from attribution for rent from real property – The new rules exclude specifically rent from real property.

CFC rules

The CFC rules are intended to prevent the deferral of Australian tax on the derivation of passive income by foreign companies. The draft legislation will introduce a new set of rules intended to target more precisely Australian resident taxpayers that control (as determined according to accounting standards) foreign companies that derive certain passive income and capital gains.

Specifically, where an Australian resident (or associate of an Australian resident) controls a foreign company at the end of the company's statutory accounting period, the company will be a CFC and the Australian resident will be taxed on an accruals basis in respect of certain passive income ("attributable income") of the CFC unless an exemption applies.

The CFC rules will not apply if:

- For financial accounts purposes, the passive income of the foreign company is less than 5% of the gross income of the foreign company (active CFC test);
- The Australian resident that controls the CFC (directly or indirectly through partnerships or trusts) is a lightly taxed entity (i.e. complying superannuation entity or life insurance company); or
- The CFC is resident in a comparable tax (listed) country at the end of the CFC's statutory accounting period and the income is considered to be comparably taxed.

Definition of CFC – Very broadly, a CFC will be a foreign company that is controlled by (or is controlled by an associate of) an Australian resident. If two or more Australian residents jointly control a foreign company, each will be treated as controlling the company. If two entities each hold 50% of the "equity interests" (as defined for tax purposes) in a foreign company, the entities are treated as jointly controlling the company.

Control and Joint Control
The concept of *control* is defined by reference to the Australian Accounting Standards AASB 127: *Consolidated and Separate Financial Statements*. Under AASB 127, control is defined as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities." For the purposes of AASB 127, there is a rebuttable presumption that control exists where an entity owns (directly or indirectly) more than half of the voting power of another entity. If the entity has half or less of the voting power, control also exists if the entity has power: • Over more than half of the voting rights by virtue of an agreement with other investors; • To govern the financial and operating policies; • To appoint or remove the majority of the members of the board of directors; • To cast the majority of votes at general meetings. The concept of *joint control* is adopted from AASB 131: *Interests in Joint Ventures*. That standard defines joint control as the "contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control."

Active CFC test – Previously referred to as the "*de minimis passive income*" exemption, the active CFC test exemption still provides an exemption from attribution if less than 5% of the income of the relevant CFC has a passive character but now is tested by reference to "financial accounts" instead of "audited financial accounts." This change removes the compliance burden where CFCs are not required to prepare audited financial statements.

Active CFC test
Active CFC test ratio = $\frac{\text{Passive financial account income}}{\text{Financial account income}}$ The test is passed if the *ratio* is *less than 5%* (i.e. there is total exemption from attribution).
Definitions Financial account income – CFC's gross income recognized in its financial accounts for the period Passive financial account income – Financial account income for the period to the extent it is referable to prima facie passive income
Financial accounts The CFC must prepare financial reports that: • Are prepared in accordance with commercially accepted accounting principles; and • Give a true and fair view of the financial position of the company.

Active business income exemption/"income of an active character" – The active business income exemption is a principal feature of the proposed new rules. The draft legislation refers to income covered by this exemption as "income of an active character." Where a CFC satisfies this exemption in relation to an amount of *prima facie passive income*, that income will not be attributable. The exemption will be satisfied if the *prima facie passive income*:

- Is attributable to a PE of the entity (in Australia or elsewhere);
- Arises from the entity competing in a market (not country specific); and
- Arises substantially from the ongoing use of labor by the entity.

Broadly, a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. In addition, the source of the *prima facie passive income*, the market *and* the use of labor must have a "substantial connection" with the country in which the PE of the CFC is located.

The principle outlined above is a significant departure from the active business income exemption that was contained in the 2010 consultation papers and represents a substantial winding back of the exemption. No examples of the operation of the proposed provision have been provided as there was no explanatory material accompanying the draft legislation.

The Australian Financial Institution (AFI) subsidiary exemption contained in the current CFC rules has been broadly retained. Details of this exemption remain subject to consultation with industry.

An integrity rule will apply where a CFC has an amount of *prima facie passive income* that has not been included in adjusted passive income and the attributable taxpayer or an associate has obtained a tax benefit (i.e. a deduction, a change in the cost base of a capital gains tax (CGT) asset or a tax offset) referable to that income. In that case, the CFC is required to include that *prima facie passive income* in its adjusted passive income. This integrity rule overrides the active business income exemption and the AFI subsidiary exemption and will only apply to listed country CFCs where the income is not comparably taxed in the CFC's country of residence.

CFCs resident in listed countries – Passive income of CFCs resident in listed countries generally will be excluded from attribution unless the income is not comparably taxed in the listed country. The exposure draft legislation does not provide complete details of this exemption as the legislation refers to the need to specify the relevant income or profits in regulations, which have not been released. Further, the legislation seems to be introducing a requirement that the income be "subject to tax" in the listed country. Currently, the only countries that are classified as listed countries for the purposes of the CFC provisions are Canada, France, Germany, Japan, New Zealand, U.K. and U.S. There is no indication that there will be any changes to this list.

Attributable income – The attributable income of a CFC is determined by first calculating the "CFC taxable income."

Attributable Income

CFC taxable income = Adjusted passive income – "Notional" deductions

Calculating adjusted passive income

Prima facie passive income → Passive income → Adjusted passive income

Step 1 – Prima facie passive income (PFPI)

- Return on equity interest (as defined for Australian tax purposes)
- Return on debt interest (as defined for Australian tax purposes)
- Rent payment
- Annuity payment
- Royalty
- Any other profit from a financial arrangement
- A profit from a CGT event that happens to an asset if the asset gave rise (or could have given rise) to an amount listed above

Step 2 – Passive income

Disregard the following PFPI:

- PFPI falling within the "*income of an active character*" exemption
- Profits from a CGT event that happens to an asset or from a financial arrangement where the asset or financial arrangement was held for the predominant purpose of producing income that falls within the "*income of an active character*" exemption or amounts that were not PFPI
- Intragroup amounts – PFPI referable to financial benefits (e.g. interest) provided from other CFC group members (financial benefit is not defined) and the financial benefit does not give rise to a deduction for the other CFC
- AFI exemption – PFPI referable to a banking business

Step 3 – Adjusted passive income

- Royalty income connected with Australia (i.e. intellectual property is automatically included (subject to the listed country comparably taxed income exemption))
- Listed countries – only income not comparably taxed will be included
- Rent from real property is not included in adjusted passive income
- PFPI that is subject to the integrity rule will be included in adjusted passive income (subject to the listed country comparably taxed income exemption)

Consistent with previous consultation papers, the base company income rules (i.e. tainted sales income, tainted services income) have been removed.

In determining the CFC taxable income, the following principles apply:

- CFC taxable income is calculated as if the CFC were an Australian resident taxpayer for the entire income year.
- Amounts must be referable to adjusted passive income to be assessable or deductible in calculating CFC taxable income for the income year.
- An amount will not be assessable or deductible to the CFC if it was actually assessable or deductible in Australia to the CFC for the income year.
- In calculating the CFC taxable income, the taxation of financial arrangement provisions and the debt/equity provisions apply. The thin capitalization rules do not apply.
- A deduction will be allowed for foreign income tax or withholding tax paid in respect of amounts included in the CFC's assessable income, although it is not clear from the exposure draft if and when this will give rise to a foreign income tax offset for that tax paid (in accordance with the current CFC rules).
- Where it is necessary to calculate the net income of a foreign partnership or trust for the purpose of calculating the CFC taxable income, the above principles apply.

Grouping relief and associated "integrity rule" – Financial benefits received by a CFC from a member of the same CFC group are exempt from attribution, provided the financial benefit has not given rise to a deduction for the CFC that provided the benefit (the term "*financial benefit*" is not defined in the draft legislation). Otherwise, the relevant *prima facie passive income* is required to be included in the adjusted passive income of the CFC in receipt of the financial benefit.

CFC group
A CFC group consists of entities that throughout the statutory accounting period: • Are CFCs of a single attributable taxpayer; • Are controlled by that attributable taxpayer; and • Are not controlled by any other attributable taxpayer.

Amount attributed – Taxpayers that are attributable taxpayers at the end of the CFC's statutory accounting period are assessed on their share of the attributable income of the CFC. Unless the CFC passes the active CFC test or the taxpayer falls within the lightly taxed entity exemption, the amount included in the attributable taxpayer's assessable income is determined by multiplying the attributable income by the taxpayer's *total participation interest* in the CFC (i.e. the sum of its direct and indirect participation interests in the CFC) at the end of the statutory accounting period.

To prevent double taxation, distributions from the CFC to the Australian shareholder will be non-assessable non-exempt (NANE) income to the extent the distribution relates to amounts previously attributed. Capital proceeds on disposal of a CFC will also be reduced to the extent of previously attributed, but undistributed, amounts.

Returns on foreign investment – Under the current rules, a non-portfolio dividend paid to a resident company by a nonresident company is treated as NANE income. A non-portfolio dividend is a dividend paid to a company that has a voting interest that amounts to at least 10% of the voting power in the company paying the dividend.

Under the changes, this dividend exemption will be restricted to distributions in respect of *equity interests* (as determined under the debt/equity rules) where the receiving company either has a *direct ordinary membership interest* of at least 10% or is an attributable taxpayer for the company paying the dividend (an attributable taxpayer will have access to the dividend exemption regardless of their percentage equity interest in the CFC).

Key changes
• Distributions on shares treated as debt interests (e.g. certain RPS and convertible notes) will no longer be eligible for the exemption; • Dividends on certain non-share equity interests (e.g. perpetual notes) will now be eligible for the exemption; and • Dividend distributions on equity interests received via trusts and partnerships will now be eligible for the exemption.

Further, the branch profits exemption has been rewritten. Effectively, the PE is treated as a CFC and the attributable income rules apply. As such, certain branch profits derived by an Australian resident company from carrying on a business through a PE in a foreign country will be treated as NANE. For these purposes, the new section appears to refer to the definition of PE in the tax legislation rather than the approach under the current branch profits exemption, which applies a treaty definition (where applicable). The exposure draft does not contain rules that would allow the branch profits exemption to apply where the PE is held through interposed partnerships or trusts (as the current section does).

Special rules for royalties – Royalties can qualify for the "*income of an active character*" exemption and the intragroup exemption. However, the "*income of an active character*" exemption and intragroup exemption will not be available for "*royalty income connected with Australia*." This refers to royalty income from intellectual property where:

- The CFC acquired the intellectual property (directly or indirectly) from a related Australian resident; and
- The CFC did not substantially develop, alter or improve the intellectual property while the CFC owned the property, such that the market value of the intellectual property is not substantially enhanced.

This provision will not apply to comparably taxed royalty income of a CFC that is a resident of a listed country at the end of a statutory accounting period.

It is not clear if the definition of royalty will be amended. The current definition includes equipment royalties.

Special rules for rent – Rent from real property is excluded from adjusted passive income. This is consistent with the internationally accepted approach that the right to tax income from real property rests with the country where the real property is located rather than the country where the investors are resident.

Foreign Accumulation Funds (FAF) rules

The FAF provisions seek to provide some limit on deferral of income in non-control situations following the repeal of the foreign investment fund (FIF) regime in 2010.

An Australian resident individual, partnership or trust may fall within the scope of the FAF provisions where the entity in which they invest constitutes a FAF. There are three requirements that must be met for an entity to constitute a FAF:

1. The entity must be either a nonresident company or a nonresident fixed trust;
2. The market value of debt interests (as defined for tax purposes) held by the entity must comprise 80% or more of the market value of the assets held by the entity; and
3. The entity must distribute 80% or less of its realized profits and gains and so much of its unrealized profits and gains held in entities it controls and is realized in those entities.

The new exposure draft significantly departs from last year's version in that it no longer requires the Commissioner of Taxation to make a determination as to the investor's purpose in making the investment, and so allows investors to self-assess. The rules also specify the percentage of profits that must be distributed by the FAF to prevent it falling within the scope of the FAF provisions rather than using the uncertain criteria of a "tax deferral benefit."

Commencement date

The commencement date for the new measures is not specified. Although the CFC reforms were initially planned to apply from 1 July 2010, it is now unlikely that the rules would have a start date before 1 July 2011. It is possible that the government could provide an option for taxpayers to elect an earlier start date of 1 July 2010. The new FAF rules could apply from 1 July 2010 since the previous FIF provisions were repealed with effect from the 2010/11 income year.

Treasury has requested that submissions on the exposure draft legislation be made by 18 March 2011.

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South Africa announces Budget 2011-2012

South Africa's Minister of Finance delivered his 2011-2012 budget speech to Parliament on 23 February 2011, which contains a broad range of proposed changes to the corporate (including international) and personal income tax rules, social contributions and indirect taxes. Below is a summary of the most important measures, particularly those affecting cross-border business, announced in the budget.

Corporate income tax provisions

Dividends tax – A dividends tax will be introduced with effect from 1 April 2012. From that date, the secondary tax on companies (STC) will be repealed and replaced with a final withholding tax of 10% imposed on the shareholder rather than the company (as is the case with the STC). A number of issues still need to be resolved in relation to the dividend tax, including the treatment of inbound foreign dividends. It appears from the budget proposals that the taxation of foreign dividends will be adjusted to align with the new dividends tax, but there is no clear guidance in this respect.

Taxation of debt instruments – Where debt instruments do not have a set term, it is impossible to calculate a yield to maturity and thus determine the amount of interest that needs to be included in the taxpayer's income. It is therefore proposed that a special calculation be introduced to reach an appropriate yield without reliance on a set term date. It also is proposed that, where debt instruments are disposed of before their maturity, any gain will be taxable as ordinary revenue (and presumably any loss deductible) because "the gain or loss reflects implied interest differentials to overall market rates." Currently, such gains or losses are generally subject to capital gains tax.

Anti-avoidance schemes – Several dividend schemes are perceived as undermining the tax base, particularly where the schemes result in tax-free dividends to a taxpayer that does not have any stake in the underlying shares or no meaningful economic risk. An example would be where the taxpayer has an offsetting derivative position covering its equity holding. It is proposed that these schemes be closed by treating the dividends in question as ordinary taxable income.

Internal company restructuring – It is proposed that where there is debt cancellation, special rules be introduced to exempt otherwise taxable gains or ordinary revenue imposed on the debtor if the debt is cancelled or reduced. This relief will be limited to insolvent debtors to ensure that this does not give rise to tax avoidance.

Industrial development zones – Currently, greenfield investments in industrial development zones qualify for additional relief. It is proposed that this relief will be expanded for labor-intensive projects in such zones.

International tax provisions

Branch tax – The tax rate applicable to foreign-owned South African branches, which is currently 33% and which serves as a simplified alternative to a branch profits tax on branch profit repatriations, will be reviewed in light of various nondiscrimination provisions in a number of South Africa's tax treaties. If the 33% branch rate falls foul of the treaties' nondiscrimination provisions as a result of the move from the STC to the dividends tax, the rate will be repealed.

Withholding tax on interest – A 10% withholding tax was enacted in 2010 on interest paid to nonresidents, with an exemption for portfolio interest. The 10% tax will apply to interest that accrues from 1 January 2013. It is proposed that the mechanisms for withholding be amended to enhance taxpayer compliance and enforcement of the tax by the South African tax authorities (SARS).

Scope of tax treaties – Double tax treaties, which apply to income and similar taxes, aim to provide taxpayers with relief against double taxation. The scope of "similar taxes" is an issue, especially because treaties have different lists of similar taxes. It is proposed that the Income Tax Act be amended to list all similar taxes to income tax, such as the impending dividends tax and withholding tax, thereby specifically providing that they qualify for tax treaty relief.

Offshore cell companies – Cell companies are generally used in self-insurance arrangements. The investor has control over the cell, but not over the company. If the company is established as a foreign company, it may be possible to prevent the company from constituting a CFC if South African residents do not hold more than 50% of the participation or voting rights. As a result, the income of the protected cell does not have to be imputed to the South African resident although the resident could, in substance, hold more than 50% of the participation rights or voting rights of that cell. It is proposed that offshore cell companies be taxed as multiple-investment entities, which will trigger imputing the income of the offshore cell for each controlling party of the cell.

Management investment funds – Mutual and private equity funds are showing an increased interest in Africa and intermediary South African management is often used to channel these funds into Africa. The use of South African management may trigger South African tax for the fund, even though the investment funds have a foreign origin and foreign destination. Although tax legislative changes made in 2010 aimed to provide relief to certain intermediary partnership and conduit entities, the vast majority of funds use offshore intermediary companies that fall outside this relief. It is proposed that these intermediary companies receive tax relief from the place of effective management test of residence to remove the negative tax consequences for funds associated with South African management.

Offshore restructurings – Many South African multinationals seek to restructure their offshore operations. Due to the exclusion of foreign group companies from the corporate rule provisions, offshore restructurings can give rise to immediate tax payable even if the restructured offshore entity remains wholly under the control of the South African group. It is proposed that tax relief be provided in these circumstances.

Foreign exchange and mark-to-market regime – Foreign currency held for business use is generally taxed on an annual mark-to-market basis. In certain circumstances, however, taxation is deferred until the exchange item is realized or completely excluded. For example, unrealized foreign exchange gains or losses on loans with nonresident connected companies fall outside the mark-to-market regime, as do certain currency hedges against the purchase of foreign shares. In theory, if assets linked to currency gains and losses are excluded or deferred, the linked instruments should also be exempt. It is therefore proposed that a further set of linked arrangements be excluded from mark-to-market taxation, which will include foreign bank loans used to fund further intra-group loans falling outside the mark-to-market taxation provisions.

Islamic finance – A number of amendments were introduced in 2010 to align the taxation of certain Islamic financial products with conventional financial instruments. This year the rules will address *ijara* products, which act like commercial finance leases. Amendments also will be made to legislation to facilitate the issue of Islamic-compliant government bonds.

Review of specific regimes – The budget targets several international tax areas for review and/or future amendment:

- A working group on international shipping has been formed;
- It is proposed that the National Treasury review the headquarter company regime, specifically with regard to concerns over double taxation and the manner of residence-based taxation; and
- Refinements will be made to the controlled foreign company legislation, particularly regarding complexity, interference with normal business conduct and unintended loopholes.

Personal income tax

Tax rates and rebates – Although tax rates will remain unchanged, increases to the tax brackets provide a reduction in the individual tax burden at all income levels (but primarily to the lower income brackets). For 2011/2012, the primary rebate for all individuals increases from ZAR 10,260 to ZAR 10,755, and the secondary rebate for persons 65 years and older increases from ZAR 5,675 to ZAR 6,012. A third rebate of ZAR 2,000 per annum for persons 75 years and older is proposed.

Interest and foreign dividend exemption – The 2011/12 interest and foreign dividend exemption will increase for persons under the age of 65 from ZAR 22,300 to ZAR 22,800 and for persons aged 65 years and older from ZAR 32,000 to ZAR

33,000. Of these total exemption amounts, the maximum exemption for foreign interest and foreign dividends remains unchanged at ZAR 3,700 per year.

Social contributions

Tax treatment of contributions to retirement funds – Several far-reaching changes to the taxation of retirement fund contributions are proposed to take effect from 1 March 2012. The proposed changes include the following:

- Contributions to a retirement funds by an employer on behalf of an employee will constitute taxable fringe benefits to the employee (currently such contributions have no tax consequences to the employee);
- Individuals will be able to claim a deduction of up to 22.5% of their taxable income for contributions to pension, provident and retirement annuity funds (currently, limited deductions are allowed and only in relation to a pension or retirement annuity fund); and
- Two annual thresholds for the deduction will be established: a minimum ZAR 12,000 and a maximum ZAR 200,000.

Indirect tax

Transfer duty – The transfer duty exemption threshold is to be increased from ZAR 500,000 to ZAR 600,000. For property acquired under purchase agreements concluded on or after 23 February 2011, the transfer duty rates will be as follows:

- First ZAR 600,000 consideration: 0%
- ZAR 600,001 to ZAR 1 million: 3%
- ZAR 1,000,000 to ZAR 1,500,000: 5%
- Excess over ZAR 1,500,000: 8%

These rates will be applicable to both legal persons (close corporations, companies and trusts) and individuals.

Other

Measures to improve tax compliance – SARS intends to make greater use of data provided by credit bureaus to build detailed taxpayer profiles and identify non-compliance. Cooperation with other tax administrations will be extended in areas of information exchange, skills transfer and audit.

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China:
Collection of Local Education Surcharge to be unified throughout country

The Shanghai and Jiangsu government authorities have announced that they will be collecting the 2% Local Education Surcharge retroactively as from 1 January 2011 and 1 February 2011, respectively. The local tax burden on enterprises in the two regions will be significantly increased by this change, particularly when considering the abolition of the long-standing exemption from the City Maintenance and Construction Tax and National Education Surcharge for foreign-invested entities (as from December 2010).

The Local Education Surcharge is imposed on both entities and individuals on the total of VAT, Business Tax and Consumption Tax payable, with the revenue collected used to finance local education. Until recently, the surcharge was only levied in certain regions of China. However, in November 2010, the Ministry of Finance issued guidance (Circular 98), urging *all* local governments to impose the Local Education Surcharge at a flat rate of 2%, with a view to unifying the application of the surcharge throughout the country.

The circulars issued by the Shanghai and Jiangsu government authorities are in response to Circular 98 and, as illustrated in the following table, the new policies will increase the total local surcharge to 13% in Shanghai and to 12% in Nanjing, the capital of Jiangsu province.

Local surcharges	Beijing	Shanghai	Nanjing
City Maintenance and Construction Tax	7%	7%	7%
National Education Surcharge	3%	3%	3%
Local Education Surcharge	Collection schedule to be confirmed	2%	2%
River Maintenance Fee	-	1%	-
Total	10%	13%	12%

Comments

For taxpayers located in regions that do not yet impose the Local Education Surcharge, or in areas where the applicable rate was less than 2%, Circular 98 creates an additional tax burden. Although the collection schedule still needs to be confirmed in some areas (such as Beijing), it is expected that the 2% surcharge will soon become applicable in all provinces throughout China.

Since the City Maintenance and Construction Tax, National Education Surcharge and Local Education Surcharge are all calculated on the VAT payable, Business Tax and Consumption Tax, there are financial implications, in particular, for taxpayers with significant indirect tax payables.

For the short term, affected taxpayers, especially in those areas where the Local Education Surcharge has not yet been imposed, should consider issuing invoices before the surcharge is levied. For the long term, a comprehensive tax planning strategy with a view to simplifying transaction procedures should be considered to eliminate or reduce unnecessary layers of transactions.

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European Union:
ECJ rules on Austrian treatment of foreign portfolio dividends

The European Court of Justice (ECJ) issued its decision on 10 February 2011 in the joined cases of *Haribo* and *Salinen AG*, which deal with Austria's disparate taxation of foreign portfolio dividends. While the ECJ confirmed part of the Austrian rules as compatible with EU law, the Court specifically found that the taxation of portfolio dividends from third countries, the requirement of enforcement assistance in the case of certain EEA countries and the absence of tax credit carryforwards in loss situations was discriminatory.

The *Haribo* and *Salinen* cases both involved Austrian companies that received portfolio dividends (through Austrian investment funds) paid by companies in EU/EEA Member States and third countries. Salinen also incurred an operating loss in the year at issue.

Under Austrian rules, dividends received from a domestic portfolio investment (i.e. dividends from a shareholding of less than 10% in an Austrian company) are tax exempt under the Corporate Income Tax Act. Portfolio dividends received from an EU/EEA company also are exempt provided that, in the case of an EEA country that is not an EU Member State (i.e. Iceland, Liechtenstein and Norway), the country had concluded a comprehensive agreement with Austria on mutual assistance, including cooperation in administrative matters and enforcement assistance. The exemption for both EU and EEA portfolio dividends will be denied, however, if the distributing company is low taxed (i.e. at a rate less than 15%) or if it benefits from substantial tax exemptions. In that case, the Austrian "switch over" clause will be triggered and the dividends will be taxed at the Austrian corporate income tax rate, with a credit granted for any foreign tax paid on the income. The taxpayer in such cases is required to prove a number of facts (such as the foreign tax rate, tax actually paid) to benefit from either the exemption or the credit. Where portfolio dividends are received from countries outside the EU/EEA, the dividends are fully taxed in Austria with no credit available.

The Austrian tax authorities refused to grant Haribo and Salinen an exemption in respect of the dividends paid by the EU/EEA and third countries. The taxpayers argued that the Austrian rules violate the free movement of capital principle in the EU/EEA Treaty (one of the four fundamental freedoms in the treaty and the only freedom that also covers third countries), which prohibits all restrictions on the movement of capital and payments between Member States and between Member States and third countries. After the taxpayers appealed to the Austrian court, the lower fiscal court referred the case to the ECJ.

ECJ ruling

Dividends from EU/EEA Member States – The ECJ concluded that, in principle, the switch over from an exemption to a foreign tax credit is in line with EU law, as is the additional administrative burden on taxpayers to demonstrate that the foreign tax was actually paid by the distributing company. However, the ECJ held that the administrative burden must not be excessive. As noted above, to qualify for the exemption from corporation tax, Austrian resident companies receiving portfolio dividends from a company established in one of the non-EU Member State EEA countries are subject to an additional condition, i.e. there must be a comprehensive agreement for mutual assistance with regard to administrative matters and enforcement between Austria and the EEA country of the distributing entity. This is not the case for resident companies receiving portfolio dividends from other resident companies. The Austrian government argued that the application of the exemption or credit method requires a capability to obtain relevant information on the distributing company. The ECJ, however, concluded that the requirement could discourage companies established in Austria from acquiring shares in companies established in non-EU Member State EEA countries and that making enforcement assistance a condition in relation to such countries was disproportionate to the objective sought because the government could obtain the information from the taxpayer's statements. The ECJ therefore held that the enforcement assistance requirement contradicts EU law.

Dividends from third countries – As noted above, under Austrian law, portfolio dividends received from third countries are subject to tax, whereas dividends from domestic portfolio holdings are exempt. The ECJ concluded that this different treatment of portfolio dividends constitutes a restriction on the free movement of capital. Portfolio dividends from third countries must be granted comparable treatment to portfolio dividends received from EU Member States. It appears, however, that there would not be a violation of the free movement of capital if third country portfolio dividends were only entitled to a foreign tax credit, rather than an exemption, even if the existence of a mutual assistance agreement with that third country were made a condition for the credit.

Finally, the ECJ held that Austria must allow a carryforward of creditable foreign corporate income taxes paid by EU/EEA or third country subsidiaries in cases where the Austria recipient company cannot use the foreign tax credit in Austria because it has an operating loss for the relevant year. However, the ECJ also stated that Austria is only required to grant a tax credit for foreign corporate income tax, not foreign withholding tax on dividends (i.e. EU Member States are not required to grant a credit for withholding tax levied on dividends in another Member State or third country).

The Austrian government has not yet made an official statement on the *Haribo/Salinen* decision, although it must initiate appropriate amendments in Parliament. The Austrian tax authorities must apply the ECJ's decision to all tax years not yet assessed. Taxpayers that have already received a final assessment may be able to request a re-assessment within one year after receipt of an original assessment, and if that deadline has expired, it may be possible to obtain application of the decision if the relevant year is re-opened in a tax audit.

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In brief

European Union – The EU Council of Ministers has adopted a directive aimed at strengthening cooperation to enable the Member States to better combat tax evasion and tax fraud. It will ensure that the OECD standard for the exchange of information on request is implemented in the EU. The Council also has discussed measures designed to strengthen and broaden the scope of the Savings Directive.

European Union – The European Commission has requested that Ireland amend its exit tax legislation for companies. Under Irish tax law, a company is taxed on its unrealized capital gains when it transfers its place of central management or control to another Member State. However, comparable transfers within Ireland are not taxed for unrealized capital gains. According to the Commission, this constitutes an infringement on the freedom of establishment under EU/EEA law. By levying a tax on unrealized capital gains only in cross-border situations, it is made less attractive to move a company abroad. The European Commission action was expected: it already has challenged comparable exit tax legislation on the transfer of companies and enterprises in other Member States.

India – The Indian Budget 2011-2012, announced on 28 February 2011, confirmed that the Direct Taxes Code will be implemented on 1 April 2012 and that the government plans to introduce the Goods and Services Tax on the same date. Controlled foreign company legislation is being introduced, but the tax charge on remittances to India from overseas will be reduced to 15% to encourage repatriation. There also are measures – applying from 1 June 2011 – to discourage dealings between Indian taxpayers and countries that do not exchange information with India. Such transactions will be deemed to be with associated parties and will be subject to the transfer pricing rules and a 30% withholding tax.

Isle of Man and Jersey – Jersey's Chief Minister has announced that the deemed dividend and full attribution regime will be abolished with effect from 1 January 2012. He said that Jersey did not necessarily agree that the provisions fall within the scope of the EU Code of Conduct on Business Taxation, but had decided to abolish them in the interests of good relations with EU Member States. The 0/10 corporate income tax regime would be maintained. The Isle of Man government has announced that its measures similar to Jersey's provisions would be abolished, and a 0/10 corporate income tax regime maintained. The EU Council of Ministers has since confirmed its view that the Jersey and Isle of Man regimes come within the Code, and given its reasons.

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